

MERRILL LYNCH, PIERCE, FENNER & SMITH
INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET
AS OF JUNE 27, 2008
(UNAUDITED)

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Member, Securities Investor Protection Corporation (SIPC)

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World Financial Center, North Tower
250 Vesey Street
New York, New York 10080

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET AS OF JUNE 27, 2008 (UNAUDITED)
(Dollars in Millions, Except Per Share Amounts)

ASSETS		LIABILITIES AND STOCKHOLDERS' EQUITY	
<i>Cash and cash equivalents</i>	\$ 2,572	Liabilities	
<i>Cash and securities segregated for regulatory purposes or deposited with clearing organizations</i>	5,855	<i>Securities financing transactions</i>	
		Payables under repurchase agreements (includes \$ 3,374 measured at fair value in accordance with SFAS No. 159)	\$ 45,188
<i>Securities financing transactions</i>		Payables under securities loaned transactions	<u>11,495</u>
Receivables under resale agreements (includes \$7,462 measured at fair value in accordance with SFAS No. 159)	14,335		<u>56,683</u>
Receivables under securities borrowed transactions	<u>65,517</u>	<i>Payables to affiliated companies (includes \$184 measured at fair value in accordance with SFAS No. 159)</i>	68,488
	<u>79,852</u>	Trading liabilities, at fair value	
<i>Trading assets, at fair value (includes securities pledged as collateral that can be sold or repledged of \$3,629)</i>		Equities and convertible debentures	11,819
Equities and convertible debentures	10,999	Derivative contracts	1,917
Mortgages, mortgage-backed, and asset-backed	9,211	U.S. government and agencies	1,428
Corporate debt and preferred stock	8,917	Corporate debt and preferred stock	1,514
Derivative contracts	2,357	Non-U.S. governments and agencies	127
Money markets	2,045	Mortgages, mortgage-backed, and asset-backed	39
Municipals	1,343	Municipals	<u>14</u>
U.S. government and agencies	689		<u>16,858</u>
Non-U.S. governments and agencies	<u>209</u>	<i>Obligations to return securities received as collateral, at fair value</i>	10,256
	<u>35,770</u>	Other Payables	
<i>Securities received as collateral, at fair value</i>	10,256	Customers	30,696
<i>Receivables from affiliated companies (includes \$562 measured at fair value in accordance with SFAS No. 159)</i>	49,571	Brokers and dealers	13,434
Other receivables		Compensation and benefits	2,843
Customers (net of allowance for doubtful accounts of \$75)	15,424	Interest and other	<u>4,776</u>
Brokers and dealers	13,571		<u>51,749</u>
Interest and other	<u>5,244</u>	<i>Long-term borrowings (includes \$282 measured at fair value in accordance with SFAS No. 159)</i>	282
	<u>34,239</u>		<u>282</u>
<i>Other investments</i>	1,688	Subordinated borrowings	<u>16,250</u>
<i>Equipment and facilities (net of accumulated depreciation and amortization of \$4,014)</i>	1,554	Stockholders' Equity	
<i>Goodwill and intangible assets</i>	565	Preferred stock, \$1,000 liquidation preference per share; par value \$1 per share; 10,000 shares authorized; 2,675 shares issued and outstanding	3
<i>Other assets</i>	586	Common stock, par value \$1,000 per share; 1,200 shares authorized; 1,000 shares issued and outstanding	1
		Paid-in capital	4,735
Total Assets	<u>\$ 222,508</u>	Accumulated other comprehensive loss, net of tax	(6)
		Accumulated deficit	<u>(2,791)</u>
		Total Stockholders' Equity	<u>1,942</u>
		Total Liabilities and Stockholders' Equity	<u>\$ 222,508</u>

See Notes to Consolidated Balance Sheet.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED BALANCE SHEET (UNAUDITED)
AS OF JUNE 27, 2008
(DOLLARS IN MILLIONS, EXCEPT SHARE AMOUNTS)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

DESCRIPTION OF BUSINESS—Merrill Lynch, Pierce, Fenner & Smith Incorporated (“MLPF&S”), together with its subsidiaries (the “Company”), acts as a broker (i.e., agent) for corporate, institutional, government, and other clients and as a dealer (i.e., principal) in the purchase and sale of corporate debt and equity securities. The Company also acts as a broker and/or a dealer in the purchase and sale of mutual funds, money market instruments, government securities, high-yield bonds, municipal securities, financial futures contracts and options. The futures business and foreign exchange activities are conducted through the Company. The Company holds memberships and/or has third-party clearing relationships with all major commodity and financial futures exchanges and clearing associations in the United States and it also carries positions reflecting trades executed on exchanges outside of the United States through affiliates and/or third-party clearing brokers. As a leading investment banking entity, the Company provides corporate, institutional, and government clients with a wide variety of financial services, including underwriting the sale of securities to the public, structured and derivative financing, private placements, mortgage and lease financing and financial advisory services, including advice on mergers and acquisitions. The Company is a wholly-owned subsidiary of Merrill Lynch & Co., Inc. (the “Parent”).

The Company also provides securities clearing services for its own account and for unaffiliated broker-dealers through its *Broadcort Division* and through its principal subsidiary, Merrill Lynch Professional Clearing Corp. (“MLPCC”). MLPCC is involved in the prime brokerage business and also makes a market in listed option contracts on various options exchanges.

The Company also provides discretionary and non-discretionary investment advisory services. These advisory services include Merrill Lynch Consults[®] Service, the Personal Investment Advisory Program, the Merrill Lynch Mutual Fund Advisor[®] program, the Merrill Lynch Mutual Fund Advisor Selects[®] program, Merrill Lynch Personal Advisor program, and Merrill Lynch Global Selects. The Company also offers fee-based financial planning services, including the Financial Foundation[®] report. The Company provides financing to clients, including margin lending and other extensions of credit.

Through its retirement group, the Company provides a wide variety of investment and custodial services to individuals through Individual Retirement Accounts and small business retirement programs. The Company also provides investment, administration, communications, and consulting services to corporations and their employees for their retirement programs, including 401(k), pension, profit-sharing and nonqualified deferred compensation plans.

BASIS OF PRESENTATION—The Consolidated Balance Sheet includes the accounts of MLPF&S and its subsidiaries and is presented in accordance with U.S. Generally Accepted Accounting Principles, which include industry practices. Intercompany balances have been eliminated. The Consolidated Balance Sheet is presented in U.S. dollars.

At June 27, 2008, approximately \$31,737 of assets, \$26,721 of liabilities and \$2,150 of subordinated borrowings were attributable to consolidated subsidiaries. The aggregate stockholders' equity of these subsidiaries was \$2,866 at June 27, 2008.

SECURITIZATION ACTIVITIES—In the normal course of business, the Company securitizes commercial and residential mortgage loans, municipal bonds and other types of financial assets. The Company may retain interests in the securitized financial assets through holding tranches of the securitization. In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a replacement of FASB Statement No. 125 (“SFAS No. 140”)*, the Company recognizes transfers of financial assets that relinquish control as sales to the extent of cash and other proceeds received. Control is considered to be relinquished when all of the following conditions have been met:

- a. The transferred assets have been legally isolated from the transferor even in bankruptcy or other receivership;
- b. The transferee has the right to pledge or exchange the assets it received or, if the entity is a qualified special purpose entity (“QSPE”) (a passive entity with significantly limited permitted activities that is used as a securitization vehicle and is limited in the type of assets it may hold, the derivatives it can enter into and the level of discretion it may exercise through servicing activities), the beneficial interest holders have that right; and
- c. The transferor does not maintain effective control over the transferred assets (e.g. the ability to unilaterally cause the holder to return specific transferred assets).

USE OF ESTIMATES—In presenting the Consolidated Balance Sheet, management makes estimates regarding:

- Valuations of assets and liabilities requiring fair value estimates;
- The outcome of litigation;
- The realization of deferred taxes and the recognition and measurement of uncertain tax positions;
- Assumptions and cash flow projections used in determining whether variable interest entities (“VIEs”) should be consolidated and the determination of the qualified status of QSPEs,
- The carrying amount of goodwill and other intangible assets;
- The amortization period of intangible assets with definite lives;
- Certain allocated liabilities, including valuation of share-based payment compensation arrangements, by the Parent; and
- Other matters that affect the reported amounts and disclosure of contingencies in the Consolidated Balance Sheet.

Estimates, by their nature, are based on judgment and available information. Therefore, actual results could differ from those estimates and could have a material impact on the Consolidated Balance Sheet, and it is possible that such changes could occur in the near term.

FAIR VALUE MEASUREMENT—The Company accounts for a portion of its financial instruments at fair value or considers fair value in its measurement. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e., the exit price). The Company accounts for

certain financial assets and liabilities at fair value under various accounting literature, including SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS No. 133”) and SFAS No. 159, *Fair Value Option for Certain Financial Assets and Liabilities* (“SFAS No. 159”). The Company also accounts for certain assets at fair value under applicable industry guidance, namely broker-dealer and investment company accounting guidance. The Company adopted SFAS No. 159 in 2007 for certain repurchase and resale financial instruments and long-term borrowings. See Note 5 to the Consolidated Balance Sheet for further information.

The Company adopted the provisions of SFAS No. 157, *Fair Value Measurements* (“SFAS No. 157”) in 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the quality of inputs used to measure fair value and enhances disclosure requirements for fair value measurements.

Fair values for certain exchange-traded derivatives, principally futures and certain options, are based on quoted market prices. Fair values for over-the-counter (“OTC”) derivative financial instruments, principally forwards, options, and swaps, represent the present value of amounts estimated to be received from or paid to a market participant in settlement of these instruments (i.e. the amount the Company would expect to receive in a derivative asset assignment or would expect to pay to have a derivative liability assumed). These derivatives are valued using pricing models based on the net present value of estimated future cash flows and directly observed prices from exchange-traded derivatives, other OTC trades, or external pricing services while taking into account the counterparty’s creditworthiness, or the Parent’s own creditworthiness, as appropriate. Determining the fair value for OTC derivative contracts can require a significant level of estimation and management judgment.

New and/or complex instruments may have immature or limited markets. As a result, the pricing models used for valuation often incorporate significant estimates and assumptions that market participants would use in pricing the instrument, which may impact the Consolidated Balance Sheet. For instance, on long-dated and illiquid contracts, extrapolation methods are applied to observed market data in order to estimate inputs and assumptions that are not directly observable. This enables the Company to mark to fair value all positions consistently when only a subset of prices are directly observable. Values for OTC derivatives are verified using observed information about the costs of hedging the risk and other trades in the market. As the markets for these products develop, the Company continually refines its pricing models to correlate more closely to the market price of these instruments.

Certain financial instruments recorded at fair value are initially measured using mid-market prices which results in gross long and short positions marked-to-market at the same pricing level prior to the application of position netting. The resulting net positions are then adjusted to fair value representing the exit price as defined in SFAS No. 157. The significant adjustments include liquidity and counterparty credit risk.

Liquidity

The Company makes adjustments to bring a position from a mid-market to a bid or offer price, depending upon the net open position. The Company values net long positions at bid prices and net short positions at offer prices. These adjustments are based upon either observable or implied bid-offer prices.

Counterparty Credit Risk

In determining fair value the Company considers both the credit risk of its counterparties, as well as the Parent’s own creditworthiness. Credit risk to third parties is generally mitigated by entering into netting and collateral arrangements. Net exposure is then valued for counterparty creditworthiness and the

resultant value is incorporated into the fair value of the respective instruments. The calculation of the credit adjustment for derivatives is generally based upon observable market credit spreads.

SFAS No. 157 requires that the Parent's own creditworthiness be considered when determining the fair value of an instrument. The approach to measuring the impact of the Parent's own credit on an instrument is the same approach as that used to measure third party credit risk.

LEGAL RESERVES—The Company has been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation arising in connection with its activities as a diversified financial services institution. The Company is also involved in investigations and/or proceedings by governmental and self-regulatory agencies. In accordance with SFAS No. 5, *Accounting for Contingencies* ("SFAS No. 5"), the Company will accrue a liability when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. In many lawsuits and arbitrations, including class action lawsuits, it is not possible to determine whether a liability has been incurred or to estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no accrual is made until that time. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, the Company cannot predict what the eventual loss or range of loss related to such matters will be.

VARIABLE INTEREST ENTITIES AND QUALIFIED SPECIAL PURPOSE ENTITIES—In the normal course of business, the Company enters into a variety of transactions with VIEs. The applicable accounting guidance requires the Company to perform a qualitative and/or quantitative analysis of each new VIE at inception to determine whether it must consolidate the VIE. In performing this analysis, the Company makes assumptions regarding future performance of assets held by the VIE, taking into account estimates of credit risk, estimates of the fair value of assets, timing of cash flows, and other significant factors. Although a VIE's actual results may differ from projected outcomes, a revised consolidation analysis is not required subsequent to the initial assessment unless a reconsideration event occurs. If a VIE meets the conditions to be considered a QSPE, it is typically not required to be consolidated. A QSPE is a passive entity whose activities must be significantly limited. A servicer of the assets held by a QSPE may have discretion in restructuring or working out assets held by the QSPE, as long as that discretion is significantly limited and the parameters of that discretion are fully described in the legal documents that established the QSPE. Determining whether the activities of a QSPE and its servicer meet these conditions requires management judgment.

IMPAIRMENT OF GOODWILL AND INTANGIBLE ASSETS—The Company makes certain subjective and complex judgments with respect to its goodwill and intangible assets. These include assumptions and estimates used to determine the fair value. The estimates used are based on historical experience, current knowledge, and available external information about future trends. The Company also makes assumptions and estimates in valuing its intangible assets and determining the useful lives of its intangible assets with definite lives.

EMPLOYEE STOCK OPTIONS—The fair value of stock options is estimated by the Parent as of the grant date based on a Black-Scholes option pricing model. The Black-Scholes model takes into account the exercise price, expected life of the option, current price of the underlying stock and its expected volatility, expected dividends and the risk-free interest rate for the expected term of the option. Certain model inputs require management to exercise judgment. The expected life of the option is based on an analysis of employee's historical exercise behavior. The expected volatility is based on the Parent's historical monthly stock price volatility for the same number of months as the expected life of the option. The fair value of the option, estimated at grant date, is not adjusted for subsequent changes in assumptions.

INCOME TAXES—The Company provides for income taxes on all transactions that have been recognized in the Consolidated Balance Sheet in accordance with SFAS No. 109, *Accounting for Income Taxes* (“SFAS No. 109”). Accordingly, deferred taxes are adjusted to reflect the tax rates at which future taxable amounts will likely be settled or realized. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. The Company assesses its ability to realize deferred tax assets primarily based on the earnings history and other factors of the Company through which the deferred tax assets will be realized as discussed in SFAS No. 109. See Note 13 to the Consolidated Balance Sheet for further discussion of income taxes.

The Company recognizes and measures its unrecognized tax benefits in accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”). The Company estimates the likelihood, based on their technical merits, that tax positions will be sustained upon examination based on the facts and circumstances and information available at the end of each period. The Company adjusts the level of unrecognized tax benefits when there is more information available, or when an event occurs requiring a change. The reassessment of unrecognized tax benefits could have a material impact on the Company’s effective tax rate in the period in which it occurs.

BALANCE SHEET CAPTIONS—The following are descriptions related to specific balance sheet captions.

Cash and Cash Equivalents—The Company defines cash equivalents as short-term, highly liquid securities and interest-earning deposits with maturities, when purchased, of 90 days or less, other than those used for trading purposes. The amounts recognized for cash and cash equivalents in the Consolidated Balance Sheet approximate fair value amounts.

Cash and Securities Segregated for Regulatory Purposes or Deposited with Clearing Organizations—The Company maintains relationships with clients and therefore it is obligated by rules mandated by its primary regulators, including the Securities and Exchange Commission (“SEC”) and the Commodities Futures Trading Commission (“CFTC”) in the United States, to segregate or set aside cash and/or qualified securities to satisfy these regulations, which have been promulgated to protect customer assets. In addition, the Company is a member of various clearing organizations at which it maintains cash and/or securities required for the conduct of its day-to-day clearance activities. The amounts recognized for cash and securities segregated for regulatory purposes or deposited with clearing organizations in the Consolidated Balance Sheet approximate fair value amounts.

Securities Financing Transactions—The Company enters into repurchase and resale agreements and securities borrowed and loaned transactions to accommodate customers and earn residual interest rate spreads (also referred to as “matched-book” transactions), obtain securities for settlement and finance firm inventory positions. The Company also engages in securities financing for customers through margin lending. See the *Other Receivables and Payables—Customers* section for additional information.

Resale and repurchase agreements are accounted for as collateralized financing transactions and may be recorded at their contractual amounts plus accrued interest or at fair value under the fair value option election in SFAS No. 159. Resale and repurchase agreements recorded at fair value are generally valued based on pricing models that use inputs with observable levels of price transparency. Resale and repurchase agreements recorded at their contractual amounts plus accrued interest approximate fair value, as the fair value of these items is not materially sensitive to shifts in market interest rates because of the short-term nature of these instruments or to credit risk because the resale and repurchase agreements are fully collateralized.

The Company's policy is to obtain possession of collateral with a market value equal to or in excess of the principal amount loaned under resale agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is generally valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged, when appropriate.

Substantially, all repurchase and resale activities are transacted under master netting agreements that give the Company the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty. The Company offsets certain repurchase and resale agreement balances with the same counterparty on the Consolidated Balance Sheet.

The Company may use qualifying securities received as collateral for resale agreements to satisfy regulatory requirements, such as Rule 15c3-3 of the SEC.

Securities borrowed and loaned transactions are recorded at the amount of cash collateral advanced or received. Securities borrowed transactions require the Company to provide the counterparty with collateral in the form of cash, letters of credit, or other securities. The Company receives collateral in the form of cash or other securities for securities loaned transactions. On a daily basis, the Company monitors the market value of securities borrowed or loaned against the collateral value and the Company may require counterparties to deposit additional collateral or return collateral pledged, when appropriate. The carrying value of these instruments approximates fair value as these items are not materially sensitive to shifts in market interest rates because of their short-term nature and/or their variable interest rates.

All firm-owned securities pledged to counterparties where the counterparty has the right, by contract or custom, to sell or repledge the securities are disclosed parenthetically in *Trading assets* on the Consolidated Balance Sheet.

Transactions where the Company acts as the lender in a securities lending agreement and receives securities that can be pledged or sold as collateral are recognized on the Consolidated Balance Sheet as an asset carried at fair value, representing the securities received (*Securities received as collateral*), and a liability for the same amount, representing the obligation to return those securities (*Obligations to return securities received as collateral*). The amounts on the Consolidated Balance Sheet result from non-cash transactions.

Trading Assets and Liabilities—The Company's trading activities consist primarily of securities brokerage and trading; underwriting; derivatives dealing and brokerage; and securities financing transactions. Trading assets and trading liabilities consist of cash instruments (such as securities) and derivative instruments used for trading purposes or for managing risk exposure in other trading inventory. See the *Derivatives* section for additional information on the accounting policy for derivatives.

Trading assets and liabilities are generally recorded on a trade date basis at fair value. Included in trading liabilities are securities that the Company has sold but did not own and will therefore be obligated to purchase at a future date ("short sales").

Derivative contracts—A derivative is an instrument whose value is derived from an underlying instrument or index, such as interest rates, equity securities, currencies, or credit spreads. Derivatives include futures, forwards, swaps or option contracts, or other financial instruments with similar characteristics. Derivative contracts often involve future commitments to exchange interest payment streams or currencies based on a notional or contractual amount (e.g., interest rate swaps or currency forwards) or to purchase or sell other financial instruments at specified terms on a specified date (e.g.,

options to buy or sell securities or currencies). Derivative activity is subject to the Parent's overall risk management policies and procedures.

SFAS No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts ("embedded derivatives") and for hedging activities. SFAS No. 133 requires that an entity recognize all derivatives as either assets or liabilities on the Consolidated Balance Sheet and measure those instruments at fair value. The accounting for changes in fair value of a derivative instrument depends on its intended use and if it is designated and qualifies as an accounting hedging instrument. The fair value of all derivatives is recorded on a net-by-counterparty basis on the Consolidated Balance Sheet where management believes a legal right of setoff exists under an enforceable netting agreement.

The Company enters into derivatives to facilitate client transactions, for proprietary trading and financing purposes, and to manage risk exposures arising from trading assets and liabilities. Derivatives entered into for these purposes are recognized at fair value on the Consolidated Balance Sheet as trading assets and liabilities in *Derivative contracts*. Such transactions entered into with affiliates are included in *Receivables from affiliated companies* and *Payables to affiliated companies*.

The Company also enters into derivatives in order to manage risk exposures arising from assets and liabilities not carried at fair value. The Company enters into fair value hedges of long-term fixed rate resale and repurchase agreements to manage the interest rate risk of these assets and liabilities. Subsequent to the adoption of SFAS No. 159, the Company may elect to account for certain of these instruments on a fair value basis rather than apply hedge accounting.

The Company also enters into hedges for its net investments in foreign operations in order to mitigate the impact of changes in exchange rates. These derivatives are reported at fair value in *Other assets* or *Interest and other payables* on the Consolidated Balance Sheet. Changes in the fair value of derivatives that are designated and qualify as hedges of a net investment in a foreign operation are recorded in the foreign currency translation adjustment within *Accumulated other comprehensive loss*.

The Company formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedging derivatives are highly effective in offsetting changes in fair value of hedged items. When it is determined that a derivative is not highly effective as a hedge, the Company discontinues hedge accounting. For fair value hedges, the Company assesses effectiveness on a prospective basis by comparing the expected change in the price of the hedge instrument to the expected change in the value of the hedged item under various interest rate shock scenarios. In addition, the Company assesses effectiveness on a retrospective basis using the dollar-offset ratio approach. When assessing hedge effectiveness, there are no attributes of the derivatives used to hedge the fair value exposure that are excluded from the assessment.

Other Receivables and Payables—Customers—Customer securities and financially settled OTC commodities transactions are recorded on a settlement date basis. Receivables from and payables to customers include amounts due on cash and margin transactions, including futures contracts transacted on behalf of the Company's customers. Due to their short-term nature, such amounts approximate fair value. Securities owned by customers, including those that collateralize margin or other similar transactions, are not reflected on the Consolidated Balance Sheet.

Other Receivables and Payables—Brokers and Dealers—Receivables from brokers and dealers primarily include amounts receivable for securities not delivered by the Company to a purchaser by the settlement date ("fails to deliver"), margin deposits, commissions and net receivables arising from unsettled trades. Payables to brokers and dealers primarily include amounts payable for securities not

received by the Company from a seller by the settlement date (“fails to receive”), and net payables arising from unsettled trades. Broker and dealer receivables and payables also include amounts related to futures contracts transacted on behalf of customers. Due to their short-term nature, the amounts recognized for brokers and dealers receivables and payables approximate fair value.

Other Receivables and Payables–Interest and Other—Interest and other receivables include interest receivable on corporate and government obligations, customer receivables, stock borrowed transactions, receivables from commissions and fees, dividends and income taxes. Interest and other payables include interest payable for corporate and government obligations, customer payables, stock loan transactions, reserves, dividends and income taxes.

Other Payables–Compensation and Benefits—Compensation and benefits payables consists of salaries payable, financial advisor compensation, incentive and deferred compensation, payroll taxes, pension and other employee benefits.

Other Investments—The Company’s other investments primarily include private equity investments accounted for at fair value and securities carried at cost or under the equity method of accounting.

Private equity investments that are held for capital appreciation and/or current income are accounted for under the AICPA Accounting and Auditing Guide, *Investment Companies* (“the Investment Company Guide”) and carried at fair value. The carrying value of private equity investments reflects expected exit values based upon market prices or other valuation methodologies, including expected cash flows and market comparables of similar companies.

Dividend distributions are generally recorded as reductions in the investment balance. Impairment testing is based on the guidance provided in Accounting Principles Board (“APB”) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and the investment is reduced when an impairment is deemed other-than-temporary.

Equipment and Facilities—Equipment and facilities primarily consist of technology hardware and software, leasehold improvements, and owned facilities. Equipment and facilities are reported at historical cost, net of accumulated depreciation and amortization, except for land, which is reported at historical cost. The cost of certain facilities shared with affiliates is allocated to the Company by the Parent based on the relative amount of space occupied.

Depreciation and amortization are computed using the straight-line method. Equipment is depreciated over its estimated useful life, while leasehold improvements are amortized over the lesser of the improvement’s estimated economic useful life or the term of the lease.

Qualifying costs incurred in the development of internal-use software are capitalized when costs exceed \$5 and amortized over the useful life of the developed software, not to exceed three years.

Goodwill and Intangible Assets—Goodwill is the cost of an acquired company in excess of the fair value of identifiable net assets at acquisition date. Goodwill is tested annually (or more frequently under certain conditions) for impairment at the reporting unit level in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (“SFAS No. 142”). Intangible assets consist primarily of value assigned to customer relationships. Intangible assets with definite lives are tested for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS No. 144”), whenever certain conditions exist which would indicate the carrying amount of such assets may not be recoverable. Intangible assets with definitive lives are amortized over their respective estimated useful lives.

Other Assets—Other assets consist primarily of prepaid pension expense, which is allocated to the Company by the Parent, related to plan contributions in excess of obligations, other prepaid expenses, deferred deal related expenses and other deferred charges.

Long-term Borrowings—Long-term borrowings arise primarily from the consolidation of VIEs that the Company is required to consolidate because QSPE status has not been met and the Company is the primary beneficiary as it retains the residual interest. In addition, it includes other VIEs where the Company is the primary beneficiary and must consolidate the funds. The amounts recognized in the Consolidated Balance Sheet approximate fair value.

Subordinated Borrowing—The Company’s funding needs are generally met by and dependent upon loans principally obtained from the Parent (see Note 8).

INCOME TAXES—The results of operations of the Company and its wholly-owned subsidiaries are included in the consolidated U.S. federal income tax return, and certain combined and unitary state tax returns of the Parent. In addition, the Company files tax returns in certain states on a stand-alone basis.

NEW ACCOUNTING PRONOUNCEMENTS—In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, on Amendment of FASB Statement No. 133* (“SFAS No. 161”). SFAS No. 161 is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity’s derivative instruments and hedging activities and their effects on the entity’s financial position, financial performance, and cash flows. SFAS No. 161 applies to all derivative instruments within the scope of SFAS No. 133. SFAS No. 161 amends the current qualitative and quantitative disclosure requirements for derivative instruments and hedging activities set forth in SFAS No. 133 and generally increases the level of disaggregation that will be required in an entity’s financial statements. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative agreements. SFAS No. 161 is effective prospectively for financial statements issued for fiscal years beginning after November 15, 2008.

In February 2008, the FASB issued FSP FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*. Under the guidance in FSP FAS 140-3, there is a presumption that the initial transfer of a financial asset and subsequent repurchase financing involving the same asset are considered part of the same arrangement (i.e. a linked transaction) under SFAS No. 140. However, if certain criteria are met, the initial transfer and repurchase financing will be evaluated as two separate transactions under SFAS No. 140. FSP FAS 140-3 is effective for new transactions entered into in fiscal years beginning after November 15, 2008. Early adoption is prohibited. The Company is currently evaluating the impact of FSP FAS 140-3 on the Consolidated Balance Sheet.

In June 2007, the Accounting Standards Executive Committee of the AICPA issued Statement of Position 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (“SOP 07-1”). The intent of SOP 07-1 is to clarify which entities are within the scope of the AICPA Audit and Accounting Guide, Investment Companies (the “Guide”). For those entities that are investment companies under SOP 07-1, the SOP also addresses whether the specialized industry accounting principles of the Guide (referred to as “investment company accounting”) should be retained by the parent company in consolidation or by an investor that accounts for the investment under the equity method because it has significant influence over the investee. On October 17, 2007, the FASB proposed an indefinite delay of the effective dates of SOP 07-1 to allow the Board to address certain implementation issues that have arisen and possibly revise SOP 07-1.

On February 15, 2007, the FASB issued SFAS No. 159. SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability, or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 was effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company adopted SFAS No. 159 in 2007. The impact of adopting SFAS No. 159 did not have an effect on beginning retained earnings.

2. RESTRUCTURING

As a result of the expense reduction initiative announced by the Parent, the Company reduced the number of full-time employees by approximately 2,136 during the first half of 2008. During the second quarter of 2008, the Company made cash payments, primarily severance related, of approximately \$29, resulting in a remaining liability balance of approximately \$142, a majority of which will be settled by the end of 2008. This liability is recorded in *Interest and other payables* in the Consolidated Balance Sheet at June 27, 2008.

3. RELATED PARTY TRANSACTIONS

The Company enters into repurchase and resale agreements and securities borrowed and loaned transactions to finance firm inventory positions and obtain securities for settlement with other companies affiliated by common ownership. The Company also engages in trading activities such as providing securities brokerage, dealing, financing and underwriting services with affiliated companies.

The Company clears certain securities and financially settled OTC commodities transactions through or for other affiliated companies on both a fully-disclosed and non-disclosed basis. Pursuant to agreements, the Company receives or pays a fee for such services.

The Company also has been engaged by an affiliate to provide services to asset management customers. Pursuant to an agreement, the Company receives a fee for such services.

Newly hired financial advisors are offered upfront cash payments as a sign-on bonus and the loan is structured as a "forgivable" loan, in which the financial advisor will be released from repayment obligations for as long as he or she remains with the Company during the vesting period. The loan is amortized on a straight-line basis over the vesting period. The outstanding loan balance will become due if employment is terminated before the vesting period. As of June 27, 2008, the Company had loans outstanding from financial advisors of \$484, which is included in *Interest and other receivables* on the Consolidated Balance Sheet.

Receivables from affiliated companies are comprised of:

Receivables under resale agreements	\$ 33,368
Receivables under securities borrowed transactions	7,811
Trading assets	2,660
Brokers and dealers	1,017
Loans	727
Customers	179
Other	<u>3,809</u>
	<u>\$ 49,571</u>

Payables to affiliated companies are comprised of:

Payables under securities loaned transactions	\$ 27,705
Payables under repurchase agreements	15,956
Customers	15,418
Due to Parent, net	5,116
Trading liabilities	3,062
Loans	429
Brokers and dealers	70
Other	<u>732</u>
	<u>\$ 68,488</u>

The Company obtains financing from the Parent in the normal course of business. Amounts due to the Parent primarily include the following: \$8,246 of U.S. dollar-denominated, uncollateralized obligations at variable interest rates based on the 30-day commercial paper rate; and \$1,637 of collateralized, short-term borrowings outstanding under two revolving loan agreements with available commitments totaling \$2,300. Borrowings outstanding under these agreements, which mature 12 months following demand, are collateralized by fixed assets and securities. Amounts due to the Parent are offset by receivables from the Parent.

As of June 27, 2008, the Company had a payable of \$208 to the Parent related to share-based compensation expenses, which is included in *Compensation and benefits payable* on the Consolidated Balance Sheet.

4. TRADING ACTIVITIES

The Company's trading activities include providing securities brokerage, dealing, financing and underwriting services to both affiliated and third party clients. While trading activities are primarily generated by client order flow, the Company also takes selective proprietary positions based on expectations of future market movements and conditions. The Company's trading strategies rely on the integrated management of its client-driven and proprietary positions, along with the related hedging and financing.

Trading activities expose the Company to market and credit risks. These risks are managed in accordance with established risk management policies and procedures put in place by the Parent.

Market Risk—Market risk is the potential change in an instrument's value caused by fluctuations in interest and currency exchange rates, equity and commodity prices, credit spreads, or other risks. The

level of market risk is influenced by the volatility and the liquidity in the markets in which financial instruments are traded.

The Company seeks to mitigate market risk associated with trading inventories by employing hedging strategies that correlate rate, price, and spread movements of trading inventories and related financing and hedging activities. The Company uses a combination of cash instruments and derivatives to hedge its market exposures. The following discussion describes the types of market risk faced by the Company.

Interest Rate Risk—Interest rate risk arises from the possibility that changes in interest rates will affect the value of financial instruments. Interest rate swap agreements, Eurodollar futures, and U.S. Treasury securities and futures are common interest rate risk management tools. The decision to manage interest rate risk using futures or swap contracts, as opposed to buying or selling short U.S. Treasury or other securities, depends on current market conditions and funding considerations.

Interest rate agreements used by the Company include caps, collars, floors, basis swaps, leveraged swaps and options. Interest rate caps and floors provide the purchaser with protection against rising and falling interest rates, respectively. Interest rate collars combine a cap and a floor, providing the purchaser with a predetermined interest rate range. Basis swaps are a type of interest rate swap agreement where variable rates are received and paid, but are based on different index rates. Leveraged swaps are another type of interest rate swap where changes in the variable rate are multiplied by a contractual leverage factor, such as four times three-month LIBOR (London Interbank Offered Rate). The Company's exposure to interest rate risk resulting from these leverage factors is typically hedged with other financial instruments.

Currency Risk—Currency risk arises from the possibility that fluctuations in foreign exchange rates will impact the value of financial instruments. Currency forwards and options are commonly used to manage currency risk. Currency swaps may also be used in situations where a long-dated forward market is not available or where the end-user needs a customized instrument to hedge a foreign currency cash flow stream. Typically, parties to a currency swap initially exchange principal amounts in two currencies, agreeing to exchange interest payments and to re-exchange the currencies at a future date and exchange rate.

Equity Price Risk—Equity price risk arises from the possibility that equity security prices will fluctuate, affecting the value of equity securities and other instruments that derive their value from a particular stock, a defined basket of stocks, or a stock index. Instruments typically used by the Company to manage equity price risk include equity options, warrants, total return swaps and baskets of equity securities. Equity options, for example, can require the writer to purchase or sell a specified stock or to make a cash payment based on changes in the market price of that stock, basket of stocks, or stock index.

Credit Spread Risk—Credit spread risk arises from the possibility that changes in credit spreads will affect the value of financial instruments. Credit spreads represent the credit risk premiums required by market participants for a given credit quality (i.e., the additional yield that a debt instrument issued by a AA-rated entity must produce over a risk-free alternative (e.g., U.S. Treasury instrument)). Certain instruments are used by the Company to manage this type of risk. Swaps and options, for example, can be designed to mitigate losses due to changes in credit spreads, as well as the credit downgrade or default of the issuer. Credit risk resulting from default on counterparty obligations is discussed in the *Counterparty Credit Risk* section.

Commodity Price Risk—The Company enters into exchange-traded contracts and financially settled OTC derivatives. Commodity contracts expose the Company to the risk that the price of the underlying commodity may rise or fall.

Counterparty Credit Risk—The Company is exposed to the risk of loss if an individual, counterparty or an issuer fails to perform its obligations under contractual terms (“default risk”). Both cash instruments and derivatives expose the Company to default risk. Credit risk arising from changes in credit spreads was previously discussed in the Market Risk section.

The Company has established policies and procedures for mitigating credit risk, including reviewing and establishing limits for credit exposure, maintaining qualifying collateral, and continually assessing the creditworthiness of counterparties.

In the normal course of business, the Company executes, settles, and finances various customer securities and commodities transactions. Execution of these transactions includes the purchase and sale of securities by the Company. These activities may expose the Company to default risk arising from the potential that customers or counterparties may fail to satisfy their obligations. In these situations, the Company may be required to purchase or sell financial instruments at unfavorable market prices to satisfy obligations to other customers or counterparties. The Company seeks to control the risks associated with its customer margin activities by requiring customers to maintain collateral in compliance with regulatory and internal guidelines.

Liabilities to other brokers and dealers related to unsettled transactions (i.e., securities failed-to-receive) are recorded at the amount for which the securities were acquired and are paid upon receipt of the securities from other brokers or dealers. In the case of aged securities failed-to-receive, the Company may purchase the underlying security in the market and seek reimbursement for losses from the counterparty.

Concentrations of Credit Risk—The Company’s exposure to credit risk, both default and credit spread, associated with its trading and other activities is measured on an individual counterparty basis, as well as by groups of counterparties that share similar attributes. Concentrations of credit risk can be affected by changes in political, industry, or economic factors. To reduce the potential for risk concentration, credit limits are established and monitored in light of changing counterparty and market conditions.

At June 27, 2008, the Company’s significant concentration of net credit risk was with the U.S. Government and its agencies. Direct exposure, which primarily results from trading asset positions in instruments issued by the U.S. Government and its agencies and the related accrued interest receivable, amounted to \$731 at June 27, 2008. The Company’s indirect exposure results from maintaining U.S. Government and agencies securities as collateral, primarily for resale agreements and securities borrowed transactions. The Company’s direct credit exposure on these transactions is with the counterparty; thus the Company has credit exposure to the U.S. Government and its agencies only in the event of the counterparty’s default. Securities issued by the U.S. Government and its agencies held as collateral for resale agreement and securities borrowed transactions at June 27, 2008 totaled \$4,712, of which \$4,540 was from affiliated companies.

The Company’s significant industry credit concentration is with financial institutions, including both affiliates and third parties. Financial institutions include other brokers and dealers, commercial banks, financing companies, insurance companies, and investment companies. This concentration arises in the normal course of the Company’s brokerage, trading, financing, and underwriting activities.

In the normal course of business, the Company purchases, sells, underwrites, and makes markets in non-investment grade instruments. These activities expose the Company to a higher degree of credit risk than is associated with trading, investing in, and underwriting investment grade instruments and extending credit to investment grade counterparties.

Concentration of Risk to the Mortgage Markets

At June 27, 2008, the Company had sizeable exposure to the mortgage markets through securities. This included:

- Net exposure of \$584 in U.S. sub-prime residential mortgage-related positions and \$2,377 in other residential mortgage-related position;
- Net exposure of \$76 in U.S. asset-backed security collateralized debt obligation (“ABS CDO”) and related secondary trading exposures; and
- Net exposure of \$1,967 in commercial real estate related positions.

Valuation of these exposures will also continue to be impacted by external market factors including default rates, rating agency actions, and the prices at which observable market transactions occur. The Company’s ability to mitigate its risk by selling or hedging its exposures is also limited by the market environment. The Company’s future results may continue to be materially impacted by the valuation adjustments applied to these positions.

Trading Derivatives—The Company’s trading derivatives (*Derivative contracts*) consist of derivatives provided to customers and derivatives entered into for proprietary trading strategies or risk management purposes. The table below presents fair values of the Company’s trading derivatives as of June 27, 2008:

	Fair Value	
	Assets	Liabilities
Swap agreements	\$ 3,028	\$ 4,415
Options	728	396
Forwards	30	82
Warrants	9	-

The above amounts include trading derivative assets of \$1,438 and trading derivative liabilities of \$2,976 with affiliated companies, and are included in *Receivables from affiliated companies* and *Payables to affiliated companies*, respectively.

The Company generally enters into International Swaps and Derivative Association, Inc. master agreements or their equivalent (“master netting agreements”) with each of its counterparties, as soon as possible. Master netting agreements provide protection in bankruptcy in certain circumstances and, in some cases, enable trading assets and liabilities with the same counterparty to be offset on the Consolidated Balance Sheet, providing for a more meaningful balance sheet presentation of credit exposure.

To reduce default risk, the Company requires collateral, principally U.S. Government and agency securities, on certain derivative transactions. From an economic standpoint, the Company evaluates default risk exposures net of related collateral. In addition to obtaining collateral, the Company attempts to mitigate default risk on derivatives by entering into transactions with provisions that enable the Company to terminate or reset the terms of the derivative contract.

5. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company adopted the provisions of SFAS No. 157 and SFAS No. 159 in 2007.

Fair Value Measurements — SFAS No. 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the quality of inputs used to measure fair value, and enhances disclosure requirements for fair value measurements. The Company accounts for a significant portion of its financial instruments at fair value or considers fair value in their measurement. The Company accounts for certain financial assets and liabilities at fair value under SFAS No. 159.

Fair Value Hierarchy

In accordance with SFAS No. 157, the Company has categorized its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

Financial assets and liabilities recorded on the Consolidated Balance Sheet are categorized based on the inputs to the valuation techniques as follows:

Level 1. Financial assets and liabilities whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market that the Company has the ability to access (examples include active exchange-traded equity securities, listed derivatives, most U.S. Government and agency securities, and certain other sovereign government obligations).

Level 2. Financial assets and liabilities whose values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 inputs include the following:

- a) Quoted prices for similar assets or liabilities in active markets (for example, restricted stock);
- b) Quoted prices for identical or similar assets or liabilities in non-active markets (examples include corporate and municipal bonds, which trade infrequently);
- c) Pricing models whose inputs are observable for substantially the full term of the asset or liability (examples include most over-the-counter derivatives, including interest rate and currency swaps); and
- d) Pricing models whose inputs are derived principally from or corroborated by observable market data through correlation or other means for substantially the full term of the asset or liability (examples include certain residential and commercial mortgage related assets, including loans, securities and derivatives).

Level 3. Financial assets and liabilities whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the asset or liability (examples include certain residential and commercial mortgage related assets and long-dated equity derivatives).

As required by SFAS No. 157, when the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest

level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Levels 1 and 2) and unobservable (Level 3). Further, it should be noted that the following tables do not take into consideration the effect of offsetting Level 1 and 2 financial instruments entered into by the Company that economically hedge certain exposures to the Level 3 positions.

A review of fair value hierarchy classifications is conducted on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification for certain financial assets or liabilities. Reclassifications impacting Level 3 of the fair value hierarchy are reported as transfers in/out of the Level 3 category as of the beginning of the quarter in which the reclassifications occur.

The following table presents the Company's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of June 27, 2008:

	Fair Value Measurements on a Recurring Basis			
	As of June 27, 2008			
	Level 1	Level 2	Level 3	Total
<i>Assets:</i>				
Securities segregated for regulatory purposes	\$ 565	\$ 175	\$ -	\$ 740
Receivables under resale agreements	-	7,462	-	7,462
Trading assets, excluding derivative contracts	13,522	17,101	2,790	33,413
Derivative contracts	371	1,986	-	2,357
Securities received as collateral	10,256	-	-	10,256
Other investments	143	948	468	1,559
Other assets	3	-	-	3
Receivables from affiliated companies ⁽¹⁾	308	1,995	298	2,601
<i>Liabilities:</i>				
Payables under repurchase agreements	\$ -	\$ 3,374	\$ -	\$ 3,374
Trading liabilities, excluding derivative contracts	13,131	1,810	-	14,941
Derivative contracts	348	1,556	13	1,917
Obligation to return securities received as collateral	10,256	-	-	10,256
Long-term borrowings	-	-	282	282
Payables to affiliated companies ⁽¹⁾	45	2,969	-	3,014

(1) Receivables from affiliated companies and payables to affiliated companies consist of trading assets, trading liabilities, receivables under resale agreements, payables under repurchase agreements and derivative contracts

Level 3 Assets and Liabilities

Level 3 trading assets primarily include auction rate securities of \$1,555, cash positions in U.S. ABS CDOs of \$498, Corporate Debt securities of \$335, other asset-backed securities of \$111 and high yield securities of \$74.

Level 3 receivables from affiliated companies (assets) primarily include auction rate securities of \$270.

Level 3 derivative contracts (liabilities) primarily relate to long-dated equity derivatives of \$13.

Level 3 long-term borrowings of \$282 relate to a real estate loan VIE.

Fair Value Option — SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. Changes in fair value for assets and liabilities for which the election is made will be recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. Certain of the Company's financial instruments are required to be accounted for at fair value under SFAS No. 133 as well as under industry level guidance. For certain financial instruments that are not accounted for at fair value under other applicable accounting guidance, the fair value option has been elected.

The following describes the rationale for electing to account for certain financial assets and liabilities at fair value, as well as the impact of instrument-specific credit risk on the fair value.

Resale and repurchase agreements

The Company elected the fair value option on a prospective basis for certain resale and repurchase agreements. The fair value option election was made based on the tenor of the resale and repurchase agreements, which reflects the magnitude of the interest rate risk. Resale and repurchase agreements collateralized by U.S. government securities were excluded from the fair value option election as these contracts are generally short-dated and therefore the interest rate risk is not considered significant. Amounts loaned under resale agreements require collateral with a market value equal to or in excess of the principal amount loaned resulting in minimal credit risk for such transactions.

At June 27, 2008, the difference between fair value and the aggregate contractual principal amount of receivables under resale agreements and payables under repurchase agreements, for which the fair value option has been elected, was not material to the Consolidated Balance Sheet.

6. SECURITIES FINANCING TRANSACTIONS

The Company enters into repurchase and resale agreements and secured borrowing and lending transactions to finance trading inventory, to obtain securities for settlement, to meet customers' needs and to earn residual interest rate spreads.

Under these agreements and transactions, the Company either receives or provides collateral, including U.S. Government and agencies, asset-backed securities, corporate debt, equity, and non-U.S. governments and agency securities. The Company receives collateral in connection with resale agreements, securities borrowing transactions, customer margin loans, and other loans. Under many agreements the Company is permitted to sell or repledge the securities received as collateral and use these securities to secure repurchase agreements, enter into securities lending transactions or deliver to counterparties to cover short positions. At June 27, 2008, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$259,112, of which \$55,254 was received from affiliated companies. The fair value of securities received as collateral that had been sold or repledged was \$161,931, of which \$34,152 have been sold or repledged to affiliated companies. In addition, \$13,510 of securities received as collateral is segregated in a special reserve account as required by Rule 15c3-3 under the Securities Exchange Act of 1934.

The Company pledges certain firm-owned assets which are included in *Trading assets* to collateralize repurchase agreements and other secured financings. Pledged securities that can be sold or repledged by the secured party are disclosed parenthetically in *Trading assets* on the Consolidated Balance Sheet. The

carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge at June 27, 2008 are as follows:

Corporate debt and preferred stock	\$ 6,417
Mortgages, mortgage-backed and asset-backed	6,186
Equities and convertible debentures	4,016
Municipals	<u>249</u>
	<u>\$ 16,868</u>

At June 27, 2008, intercompany pledged securities that can be sold or repledged by the secured party was \$1,584. Intercompany securities loaned or pledged where these counterparties do not have the right to sell or repledge was \$3,304.

7. SECURITIZATION TRANSACTIONS AND TRANSACTIONS WITH SPECIAL PURPOSE ENTITIES (“SPEs”)

In the normal course of business, the Company securitizes commercial and residential mortgage loans, municipal bonds and other types of financial assets. SPEs, often referred to as VIEs, are often used when entering into or facilitating securitization transactions. The Company’s involvement with SPEs used to securitize financial assets includes: structuring and/or establishing SPEs; selling assets to SPEs; underwriting, distributing, and making markets in securities issued by SPEs; engaging in derivative transactions with SPEs; owning notes or certificates issued by SPEs; and/or providing liquidity facilities and other guarantees to, or for the benefit of, SPEs.

The Company securitized assets of \$14,892 for the six month period ended June 27, 2008.

In certain instances, the Company retains interests in the senior tranche, subordinated tranche, and/or residual tranche of securities issued by SPEs created to securitize assets.

Retained interests are recorded on the Consolidated Balance Sheet at fair value. To obtain fair values, observable market prices are used if available. Where observable market prices are unavailable, the Company generally estimates fair value initially and on an ongoing basis based on the present value of expected future cash flows using management’s best estimates of credit losses, prepayment rates, forward yield curves, and discount rates, commensurate with the risks involved. Retained interests are held as trading assets.

Retained interests in securitized assets were approximately \$1,411 at June 27, 2008, which related primarily to residential mortgage loan and commercial mortgage and other loan securitization transactions. A portion of the retained interest balance consists of mortgage-backed securities that have limited price transparency. The majority of these retained interests include mortgage-backed securities that the Company had expected to sell to investors in the normal course of its underwriting activity. However, the timing of any sale is subject to current and future market conditions. A portion of the retained interests represent residual interests in U.S. sub-prime mortgage securitizations and is included in the Level 3 U.S. ABS CDO exposure disclosed in Note 5 to the Consolidated Balance Sheet.

The following table presents information on retained interests, excluding the offsetting benefit of financial instruments used to hedge risks, held by the Company as of June 27, 2008, arising from the Company's residential mortgage loan and commercial mortgage and other loan securitization transactions. The pre-tax sensitivities of the current fair value of the retained interests to immediate 10% and 20% adverse changes in assumptions and parameters are also shown.

	<u>Residential Mortgage Loans</u>	<u>Commercial Mortgage and Other Loans</u>
Retained interest (fair value)	\$ 1,204	\$ 207
Weighted-average life (in years)	5.5	0.9
Range	0-28.4	0-9.1
Weighted-average credit losses (rate per annum)	0.0%	0.2%
Range	0-7.8%	0-5.0%
Impact on fair value of 10% adverse change	\$ (2)	\$ (2)
Impact on fair value of 20% adverse change	\$ (3)	\$ (3)
Weighted-average discount rate	12.4%	7.6%
Range	0-100.0%	3.1%-35.0%
Impact on fair value of 10% adverse change	\$ (40)	\$ (9)
Impact on fair value of 20% adverse change	\$ (86)	\$ (17)
Weighted-average prepayment speed (CPR)	16.8%	38.6%
Range	0-24.9%	18.0-96.0%
Impact on fair value of 10% adverse change	\$ (14)	\$ (3)
Impact on fair value of 20% adverse change	\$ (28)	\$ (5)

CPR = Constant Prepayment Rate

The preceding sensitivity analysis is hypothetical and should be used with caution. In particular, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. Further, changes in fair value based on a 10% or 20% variation in an assumption or parameter generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the sensitivity analysis does not include the offsetting benefit of financial instruments that the Company utilizes to hedge risks, including credit, interest rate, and prepayment risk, that are inherent in the retained interests. These hedging strategies are structured to take into consideration the hypothetical stress scenarios above, such that they would be effective in principally offsetting the Company's exposure to loss in the event these scenarios occur.

The weighted-average assumptions and parameters used initially to value retained interests relating to securitizations that were still held by the Company as of June 27, 2008 were as follows:

	<u>Residential Mortgage Loans</u>	<u>Commercial Mortgage and Other Loans</u>
Weighted-average life (in years)	4.9	2.8
Credit losses (rate per annum)	0.0 %	0.1 %
Weighted-average discount rate	5.2 %	7.3 %
Prepayment speed assumption (CPR)	26.6 %	17.1 %

CPR = Constant Prepayment Rate

In the case of residential mortgage loan, commercial mortgage loan and other securitizations, the investors and the securitization trust have no recourse to the Company's other assets for failure of mortgage holders to pay when due.

Variable Interest Entities— FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities — an interpretation of ARB No. 51* (“FIN 46R”), requires an entity to consolidate a VIE if that enterprise has a variable interest that will absorb a majority of the variability of the VIE's expected losses, receive a majority of the variability of the VIE's expected residual returns, or both. The entity required to consolidate a VIE is known as the primary beneficiary. A QSPE is a type of VIE that holds financial instruments and distributes cash flows to investors based on preset terms. QSPEs are commonly used in mortgage and other securitization transactions. In accordance with SFAS No. 140 and FIN 46R, the Company typically does not consolidate QSPEs.

Where an entity is a significant variable interest holder, FIN 46R requires that entity to disclose its maximum exposure to loss as a result of its interest in the VIE. It should be noted that this measure does not reflect the Company's estimate of the actual losses that could result from adverse changes because it does not reflect the economic hedges the Company enters into to reduce its exposure.

The following table summarizes the Company's involvement with certain VIEs as of June 27, 2008. The table below does not include information on QSPEs or those VIEs where the Company is the primary beneficiary and holds a majority of the voting interests in the entity.

	Primary Beneficiary			Significant Variable Interest Holder	
	Total Asset Size ⁽¹⁾	Net Asset Size ⁽²⁾	Recourse To Merrill Lynch ⁽³⁾	Total Asset Size ⁽²⁾	Maximum Exposure
June 27, 2008					
Loan VIE	\$ 282	\$ 282	-	-	-

(1) This column reflects the total size of the assets held in the VIE.

(2) This column reflects the size of the assets held in the VIE after accounting for intercompany eliminations and any balance sheet netting of assets and liabilities as permitted by FIN 39.

(3) This column reflects the extent, if any, to which investors have recourse to the Company beyond the assets held in the VIE.

The Company has entered into a transaction with a VIE in which it is the primary beneficiary and therefore must consolidate the VIE or is a significant variable interest holder in the VIE. The following are the VIEs:

Loan VIEs—The Company has investments in VIEs that hold loans. The Company may be either the primary beneficiary, which would result in consolidation of the VIE, or may be a significant variable interest holder. These VIEs include entities that are primarily designed to provide financing to clients. In addition, these VIEs include securitization vehicles that the Company is required to consolidate because QSPE status has not been met and the Company is the primary beneficiary as it retains the residual interest. For consolidated VIEs that hold loans, the assets of the VIEs are recorded in *Trading assets* on the Consolidated Balance Sheet. The beneficial interest holders in these VIEs have no recourse to the general credit of the Company; their investments are paid exclusively from the assets in the VIE. The Company's inability to sell certain securities disqualified the VIEs as QSPEs, thereby resulting in the Company's consolidation of the VIEs.

8. SUBORDINATED BORROWINGS

At June 27, 2008, subordinated borrowings and credit committed under agreements with the Parent consisted of the following:

	<u>Maturity</u>	<u>Amount Outstanding</u>	<u>Total Credit Facility</u>
MLPF&S:			
Revolving Subordinated Loan	April 29, 2010	\$ 9,700	\$ 12,000
Cash Subordinated Loan	December 31, 2009	500	500
Cash Subordinated Loan	March 31, 2010	500	500
Cash Subordinated Loan	September 30, 2010	1,400	1,400
Cash Subordinated Loan	December 31, 2010	1,000	1,000
Cash Subordinated Loan	February 25, 2011	1,000	1,000
MLPCC:			
Revolving Subordinated Loan	April 30, 2010	1,650	3,850
Cash Subordinated Loan	April 30, 2010	<u>500</u>	<u>500</u>
		<u>\$ 16,250</u>	<u>\$ 20,750</u>

These borrowings, which have been approved for regulatory capital purposes for each respective company, are U.S. dollar-denominated obligations at variable interest rates based on one-month LIBOR plus a spread. The carrying value of these borrowings approximate fair value.

9. STOCKHOLDERS' EQUITY

MLPF&S is authorized to issue 1,200 shares of \$1,000 par value common stock. At June 27, 2008, there were 1,000 shares issued and outstanding.

MLPF&S is authorized to issue 1,000 shares of \$25 value preferred stock. At June 27, 2008, there were no preferred shares issued.

MLPCC is authorized to issue 10,000 shares of \$1 par value preferred stock, with a liquidation preference of 1,000 per share. At June 27, 2008, there were 2,675 preferred shares issued and outstanding.

10. COMMITMENTS, CONTINGENCIES AND GUARANTEES

Litigation—The Company has been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation arising in connection with its activities as a global diversified financial services institution.

Some of the legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or otherwise in financial distress. The Company is also involved in investigations and/or proceedings by governmental and self-regulatory agencies.

The Company believes it has strong defenses to, and where appropriate, will vigorously contest, many of these matters. Given the number of these matters, some are likely to result in adverse judgments, penalties, injunctions, fines, or other relief. The Company may explore potential settlements before a case is taken through trial because of the uncertainty, risks, and costs inherent in the litigation process. In accordance with SFAS No. 5, the Company will accrue a liability when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. In many lawsuits, arbitrations, and investigations, including almost all of the class action lawsuits, it is not possible to determine whether a liability has been incurred or to estimate the ultimate or minimum amount of that liability until the matter is close to resolution, in which case no accrual is made until that time. In view of the inherent difficulty of predicting the outcome of such matters, particularly in matters in which claimants seek substantial or indeterminate damages, the Company cannot predict what the eventual loss or range of loss related to such matters will be. The Company continues to assess these cases and believes, based on information available to it, that the resolution of these matters will not have a material adverse effect on the financial condition of the Company as set forth on the Consolidated Balance Sheet.

The actions against the Company include, but are not limited to, the following:

IPO Underwriting Fee Litigation

In re Public Offering Fee Antitrust Litigation and In re Issuer Plaintiff Initial Public Offering Fee Antitrust Litigation: Beginning in 1998, the Company was named as one of approximately two dozen defendants in purported class actions filed in the United States District Court for the Southern District of New York alleging that underwriters conspired to fix the “fee” paid to purchase certain initial public offering securities at 7% in violation of antitrust laws. These complaints have been filed by both investors and issuers in initial public offerings. On February 24, 2004, the court held that the purchaser plaintiffs’ claims for damages were barred, but declined to dismiss the claim for injunctive relief. On April 18, 2006, the court held that the issuer claim could not proceed as a class action. On September 11, 2007, the Second Circuit Court of Appeals vacated the April 18 decision and remanded the case for further proceedings on the issue of class certification. Following the remand, plaintiffs moved for class certification of the issuer class, and the defendants opposed class certification. In May of 2008, the defendants, including Merrill Lynch, agreed to settle the actions for an amount that is confidential and not material to the Company’s Consolidated Balance Sheet.

IPO Allocation Litigation

In re Initial Public Offering Securities Litigation: Beginning in 2001, the Company was named as one of the defendants in approximately 110 securities class action complaints alleging that dozens of underwriter defendants artificially inflated and maintained the stock prices of securities by creating an artificially high post-IPO demand for shares. On October 13, 2004, the district court, having previously denied defendants’ motions to dismiss, issued an order allowing certain of these cases to proceed against the underwriter defendants as class actions. On December 5, 2006, the Second Circuit Court of Appeals reversed this order, holding that the district court erred in certifying these cases as class actions. On September 27, 2007, plaintiffs again moved for class certification. On December 21, 2007, defendants filed their opposition to plaintiffs’ motion. The court has not issued a decision on the class certification issue.

Enron Litigation

Newby v. Enron Corp. et al.: On April 8, 2002, the Company was added as a defendant in a consolidated class action filed in the United States District Court for the Southern District of Texas on behalf of the

purchasers of Enron's publicly traded equity and debt securities during the period October 19, 1998 through November 27, 2001. The complaint alleges, among other things, that the Company engaged in improper transactions in the fourth quarter of 1999 that helped Enron misrepresent its earnings and revenues in the fourth quarter of 1999. The district court denied the Company's motions to dismiss, and certified a class action by Enron shareholders and bondholders against the Company and other defendants. On March 19, 2007, the Fifth Circuit Court of Appeals reversed the district court's decision certifying the case as a class action. On January 22, 2008, the Supreme Court denied plaintiffs' petition to review the Fifth Circuit's decision. The parties are currently awaiting the Court's decision on the Company's request to dismiss the case based on the Fifth Circuit's March 19, 2007 decision rejecting class certification and the Supreme Court's January 15, 2008 decision rejecting liability in another case, *Stoneridge Investment v. Scientific Atlanta*.

Auction Rate Securities-Related Litigation

In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Incorporated: On August 21, 2008, MLPF&S agreed to settlements with state regulators and the SEC staff regarding auction rate securities. As part of the settlements, MLPF&S will offer to buy back billions of dollars of auction rate securities held by its retail investors (defined to include individuals, charities, and small business investors), use its best efforts to provide liquidity solutions to institutional customers who purchased auction rate securities, and pay a \$125 fine.

Burton v. Merrill Lynch & Co., Inc., et al.: On March 25, 2008, a purported class action was filed in the U.S. District Court for the Southern District of New York against MLPF&S on behalf of persons who purchased and continue to hold auction rate securities offered for sale by MLPF&S between March 25, 2003 and February 13, 2008. The complaint alleges that MLPF&S failed to disclose material facts about auction rate securities. A similar action, captioned *Stanton v. Merrill Lynch & Co., Inc., et al.*, was filed the next day in the same court. The parties are awaiting the court's decision on motions to consolidate the two actions and to appoint lead plaintiffs and lead counsel. MLPF&S intends to vigorously defend itself in these actions

Subprime Mortgage-Related Regulatory Investigations

The Company is cooperating in government investigations related to its exposure to subprime mortgage-backed collateralized debt obligations.

Bank Sweep Programs Litigation

DeBlasio v. Merrill Lynch, et al.: On January 12, 2007, a purported class action was brought against the Company and three other securities firms in the United States District Court for the Southern District of New York alleging that their bank sweep programs violated state law because their terms were not adequately disclosed to customers. On May 1, 2007, plaintiffs filed an amended complaint, which added additional defendants. On November 12, 2007, defendants filed motions to dismiss the second amended complaint. Briefing was completed on March 6, 2008.

Employment Litigation

McReynolds v. Merrill Lynch: On November 18, 2005, a purported class action was filed in the United States District Court for the Northern District of Illinois seeking to certify a class of current and former African American Company financial advisors, as well as African Americans who applied for employment as financial advisors. Plaintiff alleges that the Company has engaged in a pattern and

practice of discrimination against African Americans in violation of federal Civil Rights statutes. The Company is vigorously contesting these claims.

Short Sales Litigation

Electronic Trading Group, LLC v. Banc of America Securities LLC, et al: On April 12, 2006, a purported class action was filed against eleven financial services firms, including the Company, in the United States District Court for the Southern District of New York. The case alleged that the defendants violated federal antitrust laws by charging unearned fees on short sales by their clients even when they failed to borrow and/or deliver stock in support of those short sales. On December 20, 2007, the court granted defendants' motion to dismiss. Plaintiffs have filed an appeal, which has been fully briefed.

Avenius v. Banc of America Securities LLC, et al: On June 22, 2006, 37 purchasers of securities of NovaStar Financial filed an action against eleven financial services firms, including the Company, in the California Superior Court in San Francisco. The case alleges that the defendants improperly depressed the price of NovaStar Financial shares by facilitating short sales that did not comply with regulatory requirements. The Company is vigorously defending itself against these charges. On July 17, 2007, the Superior Court of the State of California, County of San Francisco, rejected defendants' argument that state law claims of facilitating improper short sales were preempted by the federal securities laws. The court did not rule on the substance of the underlying claims. The defendants, including the Company, are vigorously defending themselves against the claims.

Overstock.com, Inc. v. Morgan Stanley & Co., et al: On February 2, 2007, Overstock.com brought an action in the Superior Court of the State of California, County of San Francisco, against approximately a dozen investment banks, including the Company, alleging that they violated state law by improperly facilitating short sales of Overstock.com, which artificially depressed the price of its shares. The Company is vigorously defending itself against these charges. On July 17, 2007, the Superior Court of the State of California, County of San Francisco, rejected defendants' argument that state law claims of facilitating improper short sales were preempted by the federal securities laws. The court did not rule on the substance of the underlying claims. The defendants, including the Company, are vigorously defending themselves against the claims.

Leases— The Parent and the Company have entered into various non-cancelable long-term lease agreements for premises and equipment that expire through 2024, including the World Financial Center Headquarters ("WFC"). The Company has also entered into various non-cancelable short-term equipment leases.

Future minimum rental commitments under non-cancelable leases with initial or remaining terms exceeding one year as of June 27, 2008 are presented below:

	<u>WFC</u>	<u>Other</u>	<u>Total</u>
2009	\$ 81	\$ 226	\$ 307
2010	81	220	301
2011	81	188	269
2012	81	150	231
2013	81	119	200
Thereafter	<u>20</u>	<u>312</u>	<u>332</u>
Total	<u>\$ 425</u>	<u>\$ 1,215</u>	<u>\$ 1,640</u>

The minimum rental commitments shown above have not been reduced by \$133 of minimum sublease rentals to be received in the future under non-cancelable subleases. The amounts in the above table do not include amounts related to lease renewal or purchase options or escalation clauses providing for increased rental payments based upon maintenance, utility and tax increases.

Other Commitments—In the normal course of business, the Company enters into commitments for underwriting transactions. Settlement of these transactions as of June 27, 2008 would not have had a material effect on the consolidated financial condition of the Company.

The Company also obtains letters of credit from issuing banks to satisfy various counterparty collateral requirements in lieu of depositing cash or securities collateral. Letters of credit aggregated \$995 at June 27, 2008.

The Company has commitments to purchase partnership interests, primarily related to private equity, of \$19 at June 27, 2008. The Company has also entered into agreements with providers of market data, communications, and systems consulting services. At June 27, 2008, minimum fee commitments over the remaining life of these agreements aggregated \$374. The Company entered into commitments to purchase loans of \$197 (which upon settlement of the commitment will be included in trading assets) at June 27, 2008. Other purchasing commitments amounted to \$1.

Guarantees—The Company enters into certain derivative contracts that meet the accounting definition of a guarantee under FASB Interpretation No. 45 (“FIN 45”), *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others - an Interpretation of FASB Statements No. 5, 57 and 107, and Rescission of FASB Interpretation No. 34*. FIN 45 defines guarantees to include derivative contracts that contingently require a guarantor to make payment to a guaranteed party based on changes in an underlying (such as changes in the value of interest rates, security prices, currency rates, commodity prices, indices, etc.), that relate to an asset, liability or equity security of a guaranteed party. Derivatives that meet the FIN 45 definition of guarantees include certain written options and credit default swaps (contracts that require the Company to pay the counterparty the par value of a referenced security if that referenced security defaults). The Company does not monitor, for accounting purposes, whether its clients enter into these derivative contracts for speculative purposes or hedging purposes. Accordingly, the Company has disclosed below information about certain types of written options that can potentially be used by clients to protect against changes in an underlying security, regardless of how the contracts are used by the client.

For certain derivative contracts, such as written interest rate caps and written currency options, the maximum payout could theoretically be unlimited, because, for example, the rise in interest rates or changes in foreign exchange rates could theoretically be unlimited. In addition, the Company does not monitor its exposure to derivatives in this manner. As such, rather than including the maximum payout, the notional value of these contracts has been included to provide information about the magnitude of involvement with these types of contracts. However, it should be noted that the notional value is not a reliable indicator of the Company’s exposure to these contracts.

The Company records all derivative transactions at fair value on its Consolidated Balance Sheet. As noted above, the Company does not monitor its exposure to derivative contracts in terms of maximum payout. Instead, a risk framework is used to define risk tolerances and establish limits to ensure that certain risk-related losses occur within acceptable, predefined limits. The Company economically hedges its exposure to these contracts by entering into a variety of offsetting derivative contracts and security positions.

These guarantees and their expiration are summarized below:

<u>Type of Guarantee</u>	<u>Maximum Payout/ Notional</u>	<u>Less than 1 Year</u>	<u>1 - 3 Years</u>	<u>4 - 5 Years</u>	<u>Over 5 Years</u>	<u>Carrying Value</u>
Derivative contracts ⁽¹⁾	\$ 3,738	\$ 929	\$ 2,679	\$ 100	\$ 30	\$ 242
Standby letters of credit	34	-	-	-	34	-
Performance guarantee ⁽²⁾	8	-	8	-	-	-

(1) As noted above, the notional value of derivative contracts is provided instead of the maximum payout amount, although the notional value should not be considered as a reliable indicator of the Company's exposure to these contracts.

(2) Relates to MLPCC guaranteeing on behalf of a client with a foreign stock exchange. This guarantee is secured by the assets of the client's accounts and has no expiration. No contingent liability is recorded since it is fully collateralized.

The Company provides guarantees in the form of standby letters of credit. The Company also provides guarantees to securities clearinghouses and exchanges. Under the standard membership agreement, members are required to guarantee the performance of other members. Under the agreements, if another member becomes unable to satisfy its obligations to the clearinghouse, other members would be required to meet shortfalls. The Company's liability under these arrangements is not quantifiable and could exceed the cash and securities it has posted as collateral. However, the potential for the Company to be required to make payments under these arrangements is remote. Accordingly, no liability is carried on the Consolidated Balance Sheet for these arrangements.

In connection with its prime brokerage business, the Company provides to counterparties guarantees of the performance of its prime brokerage clients. Under these arrangements, the Company stands ready to meet the obligations of its customers with respect to securities transactions. If the customer fails to fulfill its obligation, the Company must fulfill the customer's obligation with the counterparty. The Company is secured by assets in the customer's account as well as any proceeds received from the securities transaction entered into by the Company on behalf of the customer. No contingent liability is carried on the Consolidated Balance Sheet as the Company believes that potential for loss under these arrangements is remote.

In connection with its securities clearing business, the Company performs securities execution, clearance and settlement services on behalf of other broker-dealer clients for whom it commits to settle trades submitted for or by such clients, with the applicable clearing house. The Company's liability under these arrangements is not quantifiable and could exceed any cash deposit made by a client. However, the potential for the Company to be required to make unreimbursed payments under these arrangements is remote due to the contractual requirements associated with clients' activity and the regular review of clients' capital. Accordingly, no contingent liability is carried on the Consolidated Balance Sheet for these transactions.

11. EMPLOYEE BENEFIT PLANS

The Company provides retirement and other postemployment benefits to its employees under plans sponsored by the Parent.

Defined Contribution Plans—The U.S. defined contribution plans consist of the Retirement Accumulation Plan ("RAP") and the 401(k) Savings & Investment Plan ("401(k)"). These plans cover substantially all U.S. employees who have met service requirements.

Defined Benefit Pension Plans—The Parent has purchased a group annuity contract which guarantees the payment of benefits vested under a U.S. defined benefit plan that was terminated in accordance with

the applicable provisions of the Employee Retirement Income Security Act of 1974. The Company also maintains arrangements to provide certain supplemental benefits for certain U.S. employees.

Postretirement Benefits Other Than Pensions—The Company provides health and life insurance benefits to retired employees under Parent-sponsored plans that cover substantially all U.S. employees who have met age and service requirements. At June 27, 2008, neither the Company nor the Parent had funded these plans.

Postemployment Benefits—The Company provides certain postemployment benefits for employees on extended leave due to injury or illness and for terminated employees. Employees who are disabled due to non-work-related illness or injury are entitled to disability income, medical coverage and life insurance. The Company also provides severance benefits to terminated employees.

Severance benefits may be provided to terminated employees under the terms of a severance pay plan. See Note 2 for the restructuring plan announced by the Parent.

12. EMPLOYEE INCENTIVE PLANS

The Parent adopted the provisions of SFAS No. 123R in 2006. See Note 1 to the Consolidated Balance Sheet for further information.

To align the interests of employees with those of stockholders, the Parent sponsors several employee compensation plans that provide eligible employees, including those of the Company, with stock or options to purchase stock. The Company participates in several compensation plans sponsored by the Parent, which provide eligible employees with shares of the Parent's common stock or options to purchase such stock, and deferred cash compensation. These plans include the Long-Term Incentive Compensation Plans ("LTICP"), the Employee Stock Compensation Plan ("ESCP"), the Equity Capital Accumulation Plan ("ECAP"), the Employee Stock Purchase Plan ("ESPP"), the Financial Advisor Capital Accumulation Award Plan ("FACAAP"), and other deferred compensation plans and award programs.

At June 27, 2008, the Company had \$1,940 of total unrecognized compensation cost related to non-vested share-based payment compensation arrangements.

LTICP, ESCP and ECAP—LTICP, ESCP and ECAP provide for grants of equity and equity-related instruments of the Parent to certain employees. LTICP consist of the Long-Term Incentive Compensation Plan, a shareholder approved plan used for grants to executive officers, and the Long-Term Incentive Compensation Plan for Managers and Producers, a broad-based plan which was approved by the Parent's Board of Directors, but has not been shareholder approved. LTICP provide for the issuance of Restricted Shares, Restricted Units, and Non-qualified Stock Options, as well as Incentive Stock Options, Performance Shares, Performance Units, Performance Options, Stock Appreciation Rights, and other securities of the Parent. ESCP, a broad-based plan approved by shareholders in 2003, provides for the issuance of Restricted Shares, Restricted Units, Non-qualified Stock Options and Stock Appreciation Rights. ECAP, a shareholder-approved plan, provides for the issuance of Restricted Shares, as well as Performance Shares. All plans under LTICP, ESCP and ECAP may be satisfied using either treasury or newly issued shares of the Parent. As of June 27, 2008, no instruments other than Restricted Shares, Restricted Units, Non-qualified Stock Options, Performance Options and Stock Appreciation Rights had been granted.

Restricted Shares and Units—Restricted Shares are shares of the Parent's common stock carrying voting and dividend rights. A Restricted Unit is deemed equivalent in fair market value to one share of

common stock. Substantially all awards are settled in shares of common stock. Recipients of Restricted Unit awards receive cash payments equivalent to dividends. Under these plans, such shares and units are restricted from sale, transfer, or assignment until the end of the restricted period. Such shares and units are subject to forfeiture during the vesting period, for grants under LTICP, or the restricted period for grants under ECAP. Restricted share and unit grants made in 2003 through 2005 generally cliff vest in four years. Restricted share and unit grants made in 2006 and 2007 generally step vest in four years. In December 2007, the Parent modified the vesting schedule of certain previously granted stock bonus awards. As a result, all outstanding stock bonus awards held by employees other than certain current or former executive officers that were scheduled to vest on January 31, 2009, vested on January 31, 2008.

In January 2007, Participation Units were granted from LTICP under the Parent's Managing Partners Incentive Program. The awards granted under this program are fully at risk, and the potential payout varies depending on the Parent's financial performance against pre-determined return on average common stockholders' equity ("ROE") targets. One-third of the Participation Units converted into Restricted Shares on January 31, 2007. Based on the Parent's 2007 performance, no Participation Units converted on January 31, 2008. The remaining Participation Units will convert on January 31, 2009, subject to the satisfaction of minimum ROE targets determined for the 2008 fiscal year. Participation Units will cease to be outstanding immediately following conversion. If the minimum target is not met, the Participation Units will expire without being converted.

In March 2007, Participation Units were granted from LTICP under the Parent's Global Markets and Investment Banking Managing Partners ("GMI") Incentive Program. The awards granted under this program are fully at risk, and the potential payout varies depending on the Parent's financial performance against pre-determined GMI year-over-year pre-tax profit growth target. Based on the Parent's 2007 performance, no Participation Units converted on January 31, 2008. The remaining Participation Units will convert on January 31, 2009, subject to the satisfaction of minimum pre-tax growth target determined for the 2008 fiscal year. Participation Units will cease to be outstanding immediately following conversion. If the minimum target is not met, the Participation Units will expire without being converted.

The activity for Restricted Shares and Units under these plans during the first six months of 2008 for the Company follows.

	LTICP		ECAP		ESCP	
	Restricted Shares	Restricted Units	Restricted Shares	Restricted Shares	Restricted Units	Restricted Units
Outstanding at December 28, 2007	12,130,869	1,368,223	17,247	21,363,534		372,492
Granted	17,855	346,918	4,896			19,232,373
Released	(6,655,603)	(182,051)	(6,759)	(15,557,924)		(332,284)
Forfeited	(89,072)	(641,375)	-	(50,725)		(642,580)
Transferred	(674,426)	(66,660)	-	(156,127)		216
Outstanding at June 27, 2008	4,729,623	825,055	15,384	5,598,758		18,630,217

The total fair value of Restricted Shares and Units granted to the Company's retirement-eligible employees, or for which service criteria were satisfied during the first six months of 2008, was \$539. The total fair value of Restricted Shares and Units vested during the first six months of 2008 was \$1,072.

SFAS No. 123R requires the immediate expensing of share-based payment awards granted or modified to retirement-eligible employees in 2008, including awards that are subject to non-compete provisions. The table below contains awards with or without a future service requirement as follows:

	<u>No Future Service Required</u>		<u>Future Service Required</u>	
	<u>Shares/Units</u>	<u>Weighted Avg Grant Price</u>	<u>Shares/Units</u>	<u>Weighted Avg Grant Price</u>
Outstanding at December 28, 2007	25,384,788	66.30	9,867,577	83.37
Granted	6,846,768	55.58	12,755,274	55.54
Released	(22,734,621)	66.74	-	-
Forfeited	(1,423,752)	69.58	-	-
Transfers	(751,676)	77.28	(145,321)	54.29
Service criteria satisfied ⁽¹⁾	4,594,529	87.74	(4,594,529)	87.74
Outstanding at June 27, 2008	11,916,036	66.49	17,883,001	62.63

(1) Represents those awards for which employees attained requirement-eligibility or for which service criteria were satisfied during the first six months of 2008, subsequent to the grant date.

The weighted-average fair value per share or unit for grants in the first six months of 2008 follows:

	<u>2008</u>
LTICP	
Restricted Shares	\$ 49.04
Restricted Units	54.02
ECAP Restricted Shares	49.04
ESCP Plans	
Restricted Units	55.59

Non-Qualified Stock Options—Non-qualified stock options granted under LTICP in 1996 through 2000 generally became exercisable over five years; options granted in 2001 and 2002 became exercisable after approximately six months. Option and Stock Appreciation Right grants made after 2002 generally become exercisable over four years. The exercise price of these grants is equal to 100% of the fair market value (as defined in LTICP) of a share of the Parent's common stock on the date of grant. Options and Stock Appreciation Rights expire ten years after their grant date.

The total number of Stock Appreciation Rights for the Company that remained outstanding at June 27, 2008 was 7,024.

The Company's activity for Non-qualified Stock Options under LTICP for the first six months of 2008 follows:

	Options	Weighted-Average Exercise Price
	Outstanding	Price
Outstanding at December 28, 2007	58,582,586	53.21
Granted	6,199,314	55.59
Exercised	(2,286,864)	32.61
Forfeited	(64,236)	55.60
Transferred	(441,717)	60.30
Outstanding at June 27, 2008	61,989,083	54.15
Exercisable at June 27, 2008	55,833,987	53.99

All Options and Stock Appreciation Rights outstanding as of June 27, 2008 for the Company are fully vested or expected to vest.

At June 27, 2008, the weighted-average remaining contractual terms of total options outstanding and exercisable were 3.48 and 2.80 years, respectively.

The weighted-average fair value of options granted in the first six months of 2008 was \$17.58 per option.

The fair value of option awards with vesting based solely on service requirements is estimated on the date of grant based on a Black-Scholes option pricing model using the following weighted-average assumptions. Expected volatilities are based on historical volatility of ML & Co. common stock. The expected term of options granted is equal to the contractual life of the options. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected dividend is based on the current dividend rate at the time of grant.

	<u>2008</u>
Risk-free interest rate	3.1%
Expected life	6.6 yrs
Expected volatility	35.8%
Expected dividend yield	2.5%

ESPP—The ESPP, which is approved by the Parent’s shareholders, allows the Company’s eligible employees to invest from 1% to 10 % of their eligible compensation to purchase the Parent’s common stock, subject to legal limits. Purchases are made at a discount equal to 5% of the average high and low market price on the relevant investment date.

FACAAP—Under FACAAP, eligible employees in the Company’s Global Wealth Management group are granted awards generally based upon their prior year’s performance. Payment for an award is contingent upon continued employment for a period of time and is subject to forfeiture during that period. Awards granted in 2003 and thereafter are generally payable eight years from the date of grant in a fixed number of shares of the Parent’s common stock. For outstanding awards granted prior to 2003, payment is generally made ten years from the date of grant in a fixed number of shares of the Parent’s common stock unless the fair market value of such shares is less than a specified minimum value, in which case the minimum value is paid in cash.

Other Compensation Arrangements—The Company participates in Parent-sponsored deferred compensation plans in which employees who meet certain minimum compensation thresholds may participate on either a voluntary or mandatory basis. Contributions to the plans are made on a tax-deferred basis by participants. Participants’ returns on these contributions may be indexed to various Merrill Lynch mutual funds and other funds including certain Parent-sponsored investment vehicles that qualify as employee securities companies. The Company also participates in several Parent-sponsored, cash-based employee award programs, under which certain employees are eligible to receive future cash compensation, generally upon fulfillment of the service and vesting criteria for the particular program. At June 27, 2008, accrued liabilities for these plans and grants totaled \$1,600 and are recorded in *Compensation and benefits* payable on the Consolidated Balance Sheet.

When appropriate, the Company maintains various investments as an economic hedge of its liabilities to participants under these deferred compensation plans and award programs, including a derivative transaction with an affiliate. At June 27, 2008, the Company had such investments totaling \$427 in *Other investments* on the Consolidated Balance Sheet, and a derivative transaction with an affiliate effectively hedging an additional \$1,033 of the Company’s liabilities.

13. INCOME TAXES

The Company is included in the consolidated U.S. federal income tax return, and certain combined and unitary state tax returns of the Parent. In addition, the Company files tax returns in certain states on a stand-alone basis. At June 27, 2008, the Company had a current tax receivable from the Parent of \$148.

Deferred income taxes are provided for the effects of temporary differences between the tax basis of an asset or liability and its reported amount on the Consolidated Balance Sheet. These temporary differences result in taxable or deductible amounts in future years.

The Company's deferred tax assets at June 27, 2008, which are included in *Interest and other receivables*, are comprised of:

Deferred compensation	\$ 1,309
Restricted stock/Restricted units	513
Stock options	507
Depreciation	138
Net operating loss	82
Employee benefits and pension	63
Restructuring	5
Valuation and other reserves ⁽¹⁾	(8)
Valuation allowance	(36)
Other, net	<u>110</u>
Net deferred tax asset	<u>\$ 2,683</u>

(1) Primarily related to *Trading assets, Litigation and Other liabilities*.

At June 27, 2008, the Company had U.S. federal and state net operating loss carryforwards of approximately \$24 and \$1,500, respectively, which are available to offset future taxable income, if any, for fiscal years ending in 2008 through 2027. The Company also had approximately \$31 of state tax credit carryforwards expiring in various years after 2008.

The Company adopted FIN 48 effective in 2007 and recognized no change to beginning retained earnings for unrecognized tax benefits.

The Company had unrecognized tax benefits at December 28, 2007 of approximately \$118 in accordance with FIN 48. Of this total, approximately \$24 (net of federal benefit of state losses) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate in future periods.

The Parent is under examination by the Internal Revenue Service ("IRS") and other states with significant business operations, such as New York. The years under examination vary by jurisdiction.

Below is a chart of tax years that remain subject to examination by major tax jurisdictions:

Jurisdiction	Years Subject to Examination
US Federal	2005-2007
New York State and City	2002-2007
Massachusetts	2004-2007
California	1997-2007
Illinois	2004-2007
New Jersey	2004-2007
Pennsylvania	2004-2007

The IRS audit for the year 2004 was completed in the second quarter of 2008. IRS audits for the year 2005 and 2006 may be completed during the next twelve months. It is also reasonably possible that audits in states may conclude in 2008. While it is reasonably possible that a significant reduction in unrecognized tax benefits may occur within 12 months of June 27, 2008, quantification of an estimated range cannot be made at this time due to the uncertainty of the potential outcome of outstanding issues.

14. REGULATORY REQUIREMENTS

As a registered broker-dealer and futures commission merchant, MLPF&S is subject to the net capital requirements of Rule 15c3-1 (the “Rule”) under the Securities Exchange Act of 1934 (the “Act”) and capital requirements of the CFTC. Under the alternative method permitted by the Rule, the minimum required net capital, as defined, shall be the greater of 2% of aggregate debit items (“ADI”) arising from customer transactions or \$500. In addition, this alternative method also requires MLPF&S to maintain tentative net capital of at least \$1,000. At June 27, 2008, MLPF&S regulatory net capital of \$4,906 was approximately 18.9% of ADI, and its regulatory net capital in excess of the SEC minimum requirement was \$4,347. The CFTC also requires that minimum net capital should not be less than 8% of the total customer risk margin requirement plus 4% of the total non-customer risk margin requirement. At June 27, 2008, MLPF&S regulatory net capital of \$4,906 exceeded the CFTC minimum requirement of \$691 by \$4,215.

MLPCC, a fully guaranteed subsidiary of MLPF&S, is subject to the regulatory requirements promulgated by the SEC or other regulatory and exchange authorities. Net capital and excess net capital at June 27, 2008 as defined by these regulatory authorities is \$1,346 and \$1,194, respectively.

MLPF&S and MLPCC are also subject to the customer protection requirements of Rule 15c3-3 under the Act.

For the June 27, 2008 customer reserve computation, MLPF&S segregated in a special reserve account for the exclusive benefit of customers’ qualified securities with a contract value of \$9,958. Securities were obtained under resale agreements with an affiliate. Additionally, MLPF&S deposited \$19 of cash into a money market deposit special reserve account for the exclusive benefit of customers. MLPCC was in a net receivable position, and therefore had no reserve requirements.

MLPF&S and MLPCC are also required to perform a computation of reserve requirements for Proprietary Accounts of Introducing Brokers (“PAIB”) pursuant to Rule 15c3-3 of the Act. For the June 27, 2008 PAIB reserve computation, MLPF&S and MLPCC segregated in a special reserve account for the exclusive benefit of PAIB securities with a contract value of \$3,425 and \$1,430, respectively. The securities for both companies were obtained under resale agreements with an affiliate.

As futures commission merchants, MLPF&S and MLPCC are required to perform computations of the requirements of Section 4d(2) and Regulation 30.7 under the Commodity Exchange Act. As of June 27, 2008, assets segregated and secured and held in separate accounts totaled \$12,728 and \$2,493 and exceeded requirements by \$2,149 and \$598 for MLPF&S and MLPCC, respectively.

15. SUBSEQUENT EVENTS

Auction Rate Securities Related - Litigation:

On August 21, 2008, MLPF&S agreed to settlements relating to its auction rate securities (“ARS”) litigation (see Note 10 to the Consolidated Balance Sheet). Under this agreement, MLPF&S said it will accelerate the plans it first announced on August 7, 2008 to purchase ARS from its retail clients who hold an estimated \$12,000 in par value of ARS. MLPF&S individual clients, not-for-profit organization clients, including all charitable, educational and religious organizations, and small business clients who had on February 13, 2008 less than \$4 in assets at MLPF&S will have a 15-month period beginning on October 1, 2008 and ending on January 15, 2010 in which to sell their ARS to MLPF&S at par. In addition, MLPF&S has agreed to purchase ARS from other eligible clients from January 2, 2009 through January 15, 2010 at par.

It is estimated that MLPF&S retail clients eligible for the October 1, 2008 purchase currently hold an estimated \$4,000 in par value of ARS, which MLPF&S expects to be reduced to under \$3,250 in par value by October 1, 2008 as a result of announced and anticipated issuer redemptions.

Between continuing redemptions, clearing auctions and MLPF&S’ offer, MLPF&S estimates that approximately 90 percent of its retail clients who held ARS in February 2008 will either have been redeemed, refinanced or will have the choice to sell their ARS to MLPF&S by October 1, 2008.

The ARS that are owned by MLPF&S’ clients are predominantly rated AAA and not credit-impaired. In addition, the vast majority of MLPF&S’ ARS are closed-end funds and municipal ARS, with approximately only 10% related to student loan ARS.

In connection with these settlements, on August 8, 2008, MLPF&S increased its subordinated borrowings from the Parent by \$750. In addition, on August 21, 2008, the Parent increased its equity investment in MLPF&S by \$300 and MLPF&S increased its subordinated borrowings from the Parent by \$450.

MLPF&S does not expect its ARS purchases in October 1, 2008 through January 15, 2010 to have a material adverse impact on its Consolidated Balance Sheet.

Other:

On August 1, 2008, the Parent increased its equity investment in MLPF&S by \$300 and MLPF&S decreased its subordinated borrowings from the Parent by \$300.

As of August 29, 2008, MLPCC decreased its subordinated borrowings due to the Parent by \$950.

On August 30, 2008, the Company took initial steps to effect a transfer of a non-U.S. branch to an affiliate during the third quarter of 2008.

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